# INDEX


| | Page |
|---|---|
| Statement | 1 |
| The interest of the Securities and Exchange Commission | 4 |
| Discussion | 8 |
| Conclusion | 15 |


## CITATIONS

Cases:


| | |
|---|---|
| *Dauphin Corp.* v. *Redwall Corp.*, 201 F. Supp. 466 | 6 |
| *Ellis* v. *Carter*, 291 F. 2d 270 | 6 |
| *Fischman* v. *Raytheon Mfg. Co.*, 188 F. 2d 783 | 6 |
| *Hooper* v. *Mountain State Securities Corp.*, 282 F. 2d 195 | 5 |
| *Llanos* v. *United States*, 206 F. 2d 852, certiorari denied, 346 U.S. 923 | 12 |
| *Norwegian Nitrogen Products Co.* v. *United States*, 288 U.S. 294 | 9 |
| *Osborne* v. *Mallory*, 86 F. Supp. 869 | 6 |
| *Securities and Exchange Commission* v. *American Int'l Sav. & Loan Ass'n.*, 199 F. Supp. 341 | 5 |
| *Securities and Exchange Commission* v. *American Seal Sav. & Loan Ass'n.*, D. Md., No. 60 Civ. 12172 | 5 |
| *Securities and Exchange Commission* v. *Capital Gains Bureau, Inc.*, 375 U.S. 180 | 7 |
| *Securities and Exchange Commission* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344 | 12 |

Cases—Continued

| | Page |
|---|---|
| *Securities and Exchange Commission* v. *First Capital Sav. & Loan Ass'n.*, D. Md., No. 60 Civ. 12115 | 5 |
| *Securities and Exchange Commission* v. *Georgia Pacific Corp.*, S.D. N.Y., No. 66 Civil 1215 (May 23, 1966) | 5 |
| *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 258 F. Supp. 262 | 5 |
| *Vine* v. *Beneficial Finance Co.*, CCH Fed. Sec. Rep. ¶ 91,106 (C.A. 2) | 5 |
| *Securities and Exchange Commission* v. *W. J. Howey Co.*, 328 U.S. 293 | 8, 13 |

Statutes and rules:

| | |
|---|---|
| Securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. 77a, *et seq.*: | |
| Section 2(1), 15 U.S.C. 77b(1) | 8 |
| Section 3(a)(5), 15 U.S.C. 77c(a)(5) | 8 |
| Section 3(a)(12), 15 U.S.C. 78c(a)(12) | 9 |
| Section 12(2), 15 U.S.C. 77*l*(2) | 5, 6, 9 |
| Section 13, 15 U.S.C. 77m | 6 |
| Section 17, 15 U.S.C. 77q | 5, 6 |
| Section 17(a), 15 U.S.C. 77q(a) | 9 |
| Section 17(c), 15 U.S.C. 77q(c) | 9 |
| Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. 78a, *et seq.*: | |
| Section 3(a)(10), 15 U.S.C. 78c(a)(10) | 2, 8 |
| Section 10, 15 U.S.C. 78j | 4 |
| Section 10(b), 15 U.S.C. 78j(b) | 3, 5, 6 |
| Section 12(g)(2)(C), 15 U.S.C. 78*l*(g)-(2)(C) | 10 |
| Section 15, 15 U.S.C. 78*o* | 6 |
| Section 29(b), 15 U.S.C. 78cc(b) | 3 |

Statutes and rules—Continued

Rules under the Securities Exchange Act of 1934: Page

Rule 10b–5, 17 CFR 240.10b–5 ..... 3, 4, 5, 6
Rule 15c3–1, 17 CFR 240.15c3–1 ..... 7
Rule 15c1–4, 17 CFR 240.15c1–4 ..... 7

Illinois Savings and Loan Act, 32 Ill. Rev. Stat. § 701, *et seq.*:

Section 741(a)(1) ..... 2
Section 741(a)(2) ..... 2
Section 742(d)(2) ..... 2
Section 742(d)(4) ..... 2
Section 761(a) ..... 2, 13
Section 762 ..... 14
Section 768(a) ..... 2, 13
Section 778 ..... 14
Section 778(c) ..... 2

Miscellaneous:

Federal Home Loan Bank Board, *FSLIC Insured Savings and Loan Associations, Savings and Mortgage Lending Activity—Selected Balance Sheet Items, January 1967*, Table 1 (February 1967) ..... 4

Hearings on S. 875 before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess. (1933) ..... 8, 9

Hearings on H.R. 4314 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess. (1933) ..... 8, 9

Hearings on H.R. 6789, H.R. 6793 and S. 1642 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess. (1963) ..... 10

Miscellaneous—Continued Page

Hearings on S. 1642 before a Subcommittee of the Senate Committee on Banking and Currency, 88th Cong., 1st Sess. (1963)---- 10

New York Times, December 19, 1966, p. 1, col. 1 *et seq*---------- 11

3 Loss, *Securities Regulqtions* (2d ed., 1961)-- 6

Securities and Exchange Commission Release No. 26, October 22, 1934---------- 9

Securities and Exchange Commission, 32d Annual Report (1966)---------- 5

S. Rep. No. 379, 88th Cong., 1st Sess. (1963)-- 10

# In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 1301

ALEXANDER TCHEREPNIN, ET AL., PETITIONERS

*v.*

JOSEPH E. KNIGHT, ET AL.

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

## MEMORANDUM FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

The Securities and Exchange Commission is filing this memorandum *amicus curiae* because it believes that this case presents an important question in the administration of the Securities Exchange Act of 1934 which this Court should review.

### STATEMENT

This is an action brought by a group of holders of withdrawable capital shares of respondent City Savings Association. City Savings is a corporation doing business under the Illinois Savings and Loan Act (32 Ill. Rev. Stat. 701–944). Its capital is repre-

sented exclusively by withdrawable capital shares and share accounts.[1] Under Illinois law, every capital account in a savings and loan association must be "evidenced by one or more appropriate certificates; and either such certificates or an account book, or both" are required to be delivered to the shareholder (32 Ill. Rev. Stat. 768(a)). Each holder of one or more withdrawable shares is a member of the association (Section 741(a)(1)), entitled to "the vote of one share for each one hundred dollars of the aggregate withdrawal value of such accounts" or fraction thereof at meetings of the members (Section 742(d)(2)).[2] The profits of the association are apportioned, at least annually, by the declaration of dividends "on withdrawable shares and share accounts" (Section 778(c)). City Savings is in the process of liquidation, and its assets are in the custody of respondent Joseph E. Knight, Director of Financial Institutions of Illinois (Pet. App. 20).

The complaint alleges that petitioners' capital share accounts are securities within the meaning of Section 3(a)(10) of the Securities Exchange Act of 1934 (15

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[1] Although the Illinois statute permits an association's capital to be "represented by withdrawable capital accounts (shares and share accounts) or permanent reserve shares or both * * *" (32 Ill. Rev. Stat. 761(a)), it does not appear that the respondent association has ever issued anything except withdrawable capital shares. Accordingly, we do not refer herein to provisions of the state statute which would apply exclusively to associations offering permanent reserve shares.

[2] Every borrower from the association, so long as his loan remains unpaid, is also deemed a member (32 Ill. Rev. Stat. 741(a)(2)), although a borrowing member is entitled only to the vote of one share as such (Section 742(d)(4)).

U.S.C. 78c(a)(10)), that petitioners purchased such securities in reliance upon printed solicitations received from City Savings through the mail, and that such solicitations contained false and misleading statements violative of Section 10(b) of the 1934 Act (15 U.S.C. 78j(b)) and of Rule 10b–5 (17 CFR 240.10b–5) promulgated by the Securities and Exchange Commission thereunder. In particular, the complaint alleges that the solicitations represented City Savings to be a financially strong association and its shares to be a desirable investment but failed to disclose, *inter alia,* that the association was controlled by a person previously convicted of mail fraud involving savings and loan associations (R. 9), that the association had been denied federal insurance of its shareholder accounts because of its unsafe financial policies (R. 12), and that the association had been forced to restrict withdrawals by holders of previously purchased shares (R. 13). Petitioners allege that sales of shares in these circumstances were void under Section 29(b) of the 1934 Act (15 U.S.C. 78cc(b)), and they seek rescission (R. 8, 16).

The sole question presented by the petition for certiorari is whether withdrawable capital shares in a savings and loan association are securities within the meaning of the Act. That question was decided in the affirmative by the district court in denying motions to dismiss the complaint (Pet. App. 19–20). Upon an interlocutory appeal, however, the Court of Appeals for the Seventh Circuit (Judge Cummings dissenting) reversed. It held that the complaint should have been dismissed because the withdrawable capital

shares were "not encompassed in the definition of a 'security'" under the Securities Exchange Act of 1934 and that the district court therefore "lacked jurisdiction of this cause" (Pet. 30).

## THE INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission participated as an *amicus curiae* below and supports the petition for certiorari here because of the importance of this case in determining the reach of the federal securities laws administered by the Commission. Millions of Americans have currently invested more than $100 billion in savings and loan associations.[3] It is thus readily apparent that savings and loan associations are a major conduit of capital funds and play a significant role in the nation's capital market. Congress has charged the Commission with responsibility for fostering the integrity of that market under the federal securities laws. The decision of the court of appeals withholds from a large portion of the investing public the protection afforded by the antifraud provisions of the 1934 Act (Section 10) and the regulations fashioned by the Commission thereunder (17 CFR 240.10). The decision not only precludes

[3] In January, 1967 approximately $110,131,000,000 of savings capital were invested in 40,921,000 accounts in the 4511 savings and loan associations insured by the Federal Savings and Loan Insurance Corporation, representing about 96% of the resources of all operating savings and loan associations. Federal Home Loan Bank Board, *FSLIC Insured Savings and Loan Associations, Savings and Mortgage Lending Activity—Selected Balance Sheet Items, January 1967*, Table 1 (February, 1967).

private investors in withdrawable shares of savings and loan associations from seeking relief under Section 10b of the Act and Rule 10b–5, but also denies the Commission power to proceed under those provisions for the the protection of such investors,[4] since it wholly excludes withdrawable capital shares of savings and loan associations from the reach of the Act.[5]

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[4] Such investors have been protected by action of the Commission pursuant to the Securities Act of 1933. See *Securities and Exchange Commission* v. *First Capital Sav. & Loan Ass'n.*, (D. Md., No. 60 Civ. 12115), and *Securities and Exchange Commission* v. *American Seal Sav. & Loan Ass'n*, (D. Md., No. 60 Civ. 12172), where the Commission obtained injunctions by consent based upon complaints which alleged violation of the antifraud provisions of the Securities Act of 1933 in the offer and sale of "Savings Deposit Pass Books"; cf. *Securities and Exchange Commission* v. *American Int'l Sav. & Loan Ass'n*, 199 F. Supp. 341 (D. Md., 1961), where an injunction was granted against an organization which, because found not to be qualified for the exemption contained in Section 3(a)(5) of the Securities Act, was held to have failed to register, under Section 5 of the Act, various securities including "preferred stock" evidenced by deposit books rather than certificates, 199 F. Supp. at 346, 351.

The prevention of deceptive and manipulative practices through litigation under Section 10 of the 1934 Act has constituted an important aspect of the Commission's work. See, *e.g.*, *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 258 F. Supp. 262 (S.D.N.Y.) (appeal pending); *Securities and Exchange Commission* v. *Georgia Pacific Corp.*, No. 66 Civ. 1215 S.D.N.Y. (May 23, 1966); Securities and Exchange Commission, *32d Annual Report* (1966), pp. 114–116. Section 10b has also become an increasingly effective tool in the hands of private litigants. See *Vine* v. *Beneficial Finance Co.*, CCH Fed. Sec. Rep. ¶91,906 (C.A. 2); *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195 (C.A. 5).

[5] We recognize that the decision of the court of appeals may not affect the applicability to savings and loans shares of the antifraud provisions contained in Sections 12(2) and 17 of the Securities Act of 1933 (15 U.S.C. 77*l*(2) and 77*q*). Nevertheless, for a number of reasons, those provisions may be appre-

Furthermore, the significance of the decision below is not limited to the antifraud provisions of the 1934 Act. In holding that capital share accounts are not securities under the Act, the court of appeals necessarily exempted brokers and dealers in such shares from the registration requirements of Section 15 (15

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ciably less satisfactory implements for preventing misleading and manipulative practices. Section 12(2) of the 1933 Act (15 U.S.C. 77*l*(2)), which expressly provides for liability of persons selling securities on the basis of misleading statements, has a specific requirement of privity, provides no relief where a fraudulent sale is accomplished without any disclosure whatsoever and is subject to a very short statute of limitations. See Section 13 (15 U.S.C. 77m). While certain of these restrictions are not applicable to Section 17(a) of the 1933 Act, it is by no means clear that a private cause of action can be maintained under Section 17. See *Ellis* v. *Carter*, 291 F. 2d 270, 273–274 (C.A. 9), *Dauphin Corp.* v. *Redwall Corp.*, 201 F. Supp. 466, 468–469 (D. Del.); 3 Loss, *Securities Regulation* 1781–1787 (2d ed. 1961). But cf. *Osborne* v. *Mallory*, 86 F. Supp. 869, 878–879 (S.D. N.Y.); *Fischman* v. *Raytheon Mfg. Co.*, 188 F. 2d 783, 787 n. 2 (C.A. 2). Furthermore Section 10(b) of the 1934 Act and Rule 10b–5 apply to fraud "in connection with" securities transactions, as distinguished from fraud "in" securities transactions, and these provisions are applicable not only to fraud by sellers but also to fraud by purchasers of securities. Fraud in the purchase of savings and loan share accounts could occur whenever there may be uncertainty as to the time or amount of payment, as when an association is in liquidation. (As noted, page 9, *infra*, such shares have been traded on a securities exchange.) Finally, the 1933 Act does not authorize the Commission to adopt rules and regulations, whereas the rule making power under Section 10 of the 1934 Act has enabled the Commission to elaborate upon the broad statutory prohibitions in the light of practical experience in combatting a wide variety of manipulative and deceptive devices. Such rules have, we believe, significantly enhanced the effectiveness of the antifraud provisions of the 1934 Act.

U.S.C. 78*o*). A number of firms registered with the Commission under the Act as brokers and dealers handle only savings and loan share accounts; other firms deal in these interests as well as in other types of securities. Under the decision of the court of appeals, the former would not be required to register at all and would not be subject to Commission rules relating to their financial responsibility[6] and to the manner of their dealing with investors;[7] regulation of the latter would not extend to their activities with respect to savings and loan accounts.

Finally, quite apart from its bearing on savings and loan shares, the highly restrictive reading given the statutory definition of the term "security" presents a broader threat to the Commission's efforts to deal with novel types of financial instruments as they appear. Thus the court concluded that only an instrument "commonly known as a security" can fall within the statutory definition (Pet. App. 24). That approach rejects the more flexible analysis of economic realities which the Commission believes must be employed if the Commission is to serve effectively the remedial purposes intended by Congress. See *Securities and Exchange Commission* v. *Capital Gains Bureau, Inc.*, 375 U.S. 180, 195; *Securities and Exchange*

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[6] Rule 15c3–1, 17 CFR 240.15c3–1.

[7] See, *e.g.*, Rule 15c1–4, 17 CFR 240.15c1–4, which requires that the customer in over-the-counter transactions be advised in writing whether the firm has dealt with him as a broker or a dealer, and in the former event the source and amount of any commission. Some savings and loan associations pay commissions for successful solicitation by brokers.

*Commission* v. *W. J. Howey Co.*, 328 U.S. 293, 298, 301.

## DISCUSSION

The question which petitioners present is whether the protections of the Securities Exchange Act of 1934 are available to the holders of some forty million share accounts who have entrusted billions of dollars to the persons who manage savings and loan associations. We believe that the question is important, that it was wrongly decided by the court of appeals, and that it merits review by this Court.

1. "Security" is defined in both the Securities Act of 1933 and the Securities Exchange Act of 1934 to mean, *inter alia*, "stock" and "transferable share."[8] The legislative history of the Securities Act shows that withdrawable shares issued by savings and loan associations were unquestionably considered to be securities within this definition by the members of Congress most intimately involved in the passage of that Act and the Securities Exchange Act[9] and who found it appropriate to exempt such shares from registration under the Securities Act (Section 3(a)(5),

[8] Section 2(1) of the Securities Act, 15 U.S.C. 77b(1); Section 3(a)(10) of the Securities Exchange Act, 15 U.S.C. 78c(a)(10).

[9] See Hearings on H.R. 4314 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess. 70–80 *passim;* Hearings on S. 875 before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess. 50–54, 99–101, 110–113 *passim* (1933).

15 U.S.C. 77c(a)(5)) while leaving them subject to its antifraud provisions (Sections 12(2), 17 (a) and (c), 15 U.S.C. 77*l*(2), 77*q* (a) and (c)).[10] There is no suggestion in the legislative history of the Securities Exchange Act that withdrawable shares were not intended to be included within the broad definition of security contained therein. Indeed, within a few months after passage of the 1934 Act the newly-created Securities and Exchange Commission temporarily exempted "passbooks of * * * savings and loan companies" which were then "being traded on the Cleveland Stock Exchange" from the provisions of Sections 7, 8, 12, and 13 of that Act. See Securities and Exchange Commission Release No. 26, October 22, 1934. The limited exemption granted by the Commission, as authorized by Section 3(a)(12), 15 U.S.C. 78c(a)(12), bespeaks the Commission's understanding that such passbooks were securities within the meaning of the Act. That understanding, dating from the earliest days of the Commission's work and virtually contemporaneous with the passage of the Act, is entitled to particular weight. See *Norwegian Nitrogen Products Co.* v. *United States,* 228 U.S. 294, 315.

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[10] Industry representatives welcomed application of the antifraud provisions while seeking the exemption from registration, see House Hearings, *supra* n. 9, at 70–80 (testimony of Mr. Morton Bodfish, Executive Manager, United States Building and Loan League); Senate Hearings, *supra*, n. 9, at 50–54 (testimony of Mr. C. Clinton James, Chairman, Federal Legislative Committee of the United States Building and Loan League).

Perhaps because savings and loan associations are subject to state regulatory supervision, over the years the Commission has rarely found occasion to seek to enjoin violations of the federal securities laws by such associations and this accounts for the paucity of case law. But in 1964 Congress clearly recognized that withdrawable shares are securities as defined in the Securities Exchange Act and granted withdrawable shares an exemption from the expanded registration requirements, applicable only to equity securities, adopted by amendment that year. See Section 12(g)(2)(C), 15 U.S.C. 78*l*(g)(2)(C).[11]

Moreover, a variety of misleading practices have been recognized as accompaniments of an intensification of competition among financial institutions during the last few years. Thus on December 16, 1966, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank

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[11] If it were not apparent from the language of the exemption, the legislative history makes clear that the equity securities granted exemption are withdrawable share accounts. See, *e.g.*, S. Rep. No. 379, 88th Cong., 1st Sess. 61 (1963). The Commission recognized the need for an explicit exemption if withdrawable share accounts were to be relieved from registration. See Technical Statement of the Securities and Exchange Commission, Hearings on H.R. 6789, H.R. 6793 and S. 1642 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess. 211, 215 (1963); Memorandum of the Securities and Exchange Commission, *id.* at 1360, 1361. See also Letter from Mr. Glen Troop, Staff Vice-President, United States Savings and Loan League to Senator Harrison A. Williams, Jr., June 12, 1963, Hearings on S. 1642 before a Subcommittee of the Senate Committee on Banking and Currency, 85th Cong., 1st Sess. 256–257 (1963).

Board, and the Board of Governors of the Federal Reserve System found it appropriate to point out to their respective constituencies that "[i]n recent years, competition among financial institutions for funds has become intense. An outgrowth of such competition has been the development and use by a few institutions of advertising practices that could be detrimental to the public's attitude toward the nation's financial system. In some respects, certain of the advertising practices are considered misleading." These agencies then outlined certain minimum standards of disclosure to be observed by financial institutions and called attention to the Commission's opinion "that deposit and share accounts are subject to the anti-fraud provisions of the Securities Act of 1933 and the Securities and Exchange Act of 1934 and that advertisements by financial institutions that are contrary to such principles may violate those anti-fraud provisions." See New York Times, December 19, 1966, p. 1, col. 1, p. 22, cols. 4–5.

2. So far as we are aware, the decision below stands alone in holding, under any of the federal securities laws, that a security is not involved where, both in form and in substance, the use or management of other people's money has been solicited and obtained upon a promise of income to be derived from the management of investments pooled in a common enterprise. In this regard it is significant to observe that the opinion of the majority below cites no direct authority in support of its holding.

In reaching its conclusion, the court of appeals departed from the principles enunciated in *Securities and Exchange Commission* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344, where this Court rejected the contention that it should "constrict the more general terms [of the definition of 'security' contained in the Securities Act] substantially to the specific terms which they follow" (320 U.S. at 350). The Court held instead that it could not

> * * * read out of the statute these general descriptive designations merely because more specific ones have been used to reach some kinds of documents. Instruments may be included within any of these definitions, as matter of law, if on their face they answer to the name or description. [320 U.S. at 351.]

The court below held that the "type of interest now before us, if it is covered by [the statutory] definition, must be 'an instrument commonly known as a security' " (Pet. 24). It thus constricted the specific as well as the general terms of the broad definition attempted by Congress to the narrow scope of a single phrase.[12]

The court of appeals failed to recognize that the statutory definition "embodies a flexible rather than

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[12] In contrast, the Court of Appeals for the Ninth Circuit, in *Llanos* v. *United States*, 206 F. 2d 852, 854, certiorari denied, 346 U.S. 923, expressly rejected the contention that the phrase "'any interest or instrument commonly known as a "security"' limits those which come before" in the definition of security contained in the Securities Act.

a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profit." *Securities and Exchange Commission* v. *W. J. Howey Co.*, 328 U.S. 293, 299. Had it done so, it would have recognized that a savings and loan share "answer[s] to the name or description" of "transferable share" or "stock"; that the certificate or account book which is required to be delivered to the shareholder (32 Ill. Rev. Stat. 768(a)) is a "certificate of interest or participation in any profit-sharing agreement"; and that the contract entered into between the association and each investor is an "investment contract" as this Court construed that term in *Howey*—all of which are defined to be securities under both the Securities Act and the Securities Exchange Act.

The shareholders of a savings and loan association, like the investors in *Securities and Exchange Commission* v. *W. J. Howey Co.*, 328 U.S. 293, "provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed." 328 U.S. at 300. Indeed, the shareholders of the respondent savings and loan association have provided all of its capital (32 Ill. Rev. Stat. 761(a)), are the only persons en-

titled to share in its profits (Sections 762, 778), and may have surrendered even residual control of their common investment by execution of irrevocable proxies to management (see Pet. 24).

The court of appeals relied heavily on the fact that the phrase "evidence of indebtedness," appearing in the 1933 Act's definition of a security, was omitted from the definition in the 1934 Act. Whatever significance, if any, that omission may have, it clearly cannot signify, as the court supposed, that instruments creating a debtor-creditor relationship are not within the coverage of the Act, since "security" is defined to include "note," "bond" and "debenture," excluding only short term commercial paper. But even if the court were correct in supposing that evidences of indebtedness do not qualify as securities under the 1934 Act, that supposition is irrelevant here since there is no basis whatever for regarding petitioners as creditors when they have no claim for interest on their accounts but participate in the profits of the enterprise. On the contrary, it is precisely to be given the status of creditors that petitioners press this suit (R. 16).

## CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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MAY 1967.

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